In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 705

THE GABRIEL COMPANY, A CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 157–167) is reported at 13 T. C. 559. The opinion of the Court of Appeals (R. 190–204) is reported at 186 F. 2d 786.

JURISDICTION

The judgment of the Court of Appeals was entered February 6, 1951. (R. 189.) The petition for a writ of certiorari was filed April 30, 1951. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether in computing its excess profits tax the taxpayer corporation may include in its "equity invested capital," as defined in Section 718 (a) of the Internal Revenue Code, profits realized by an underwriter on the sale of its stock.

STATUTE INVOLVED

Internal Revenue Code:

> SEC. 718 [Added by Section 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.
>
> (a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—
>
> (1) *Money Paid In.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;
>
> (2) *Property Paid In.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. * * *
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> * * * * *

(26 U. S. C. 1946 ed., Sec. 718.)

STATEMENT

The facts are stipulated (R. 65–101) and were found by the Tax Court as stipulated (R. 158–164). They may be summarized as follows:

Taxpayer corporation was organized in 1925 pursuant to an agreement between Foster, sole proprietor of a business, and Otis & Company, investment bankers. Under the agreement Otis was to market all of taxpayer's Class A (non-voting) stock to the public at a reasonable profit, and taxpayer was to purchase Foster's business assets with the net cash proceeds and one-half of taxpayer's Class B (voting) stock. Pursuant to the agreement, Otis organized the taxpayer corporation and sold to the public on a "when issued" basis all of taxpayer's authorized Class A stock (198,000 shares) at $25 per share, or a total of $4,950,000. Out of the proceeds Otis paid over to Foster on taxpayer's behalf $4,358,705.70, the cash portion of the price payable by taxpayer for Foster's business; and Foster transferred his business assets to taxpayer in exchange for that amount of cash and 1,000 shares (one-half) of taxpayer's Class B stock. For its underwriting services Otis retained the difference between what it paid for taxpayer's Class A stock ($4,358,705.70) and the price at which it sold the stock to the public ($4,950,000), and in addition it received 1,000 shares (one-half) of the Class B stock. (R. 68–70, 75–78, 85–88, 158–162.)

In its excess profits tax returns for 1942 and subsequent years taxpayer claimed equity invested capital of $5,106,204.26 as of the beginning of 1942. The Commissioner determined that a portion of the amount claimed represented underwriter's commissions not includible in taxpayer's equity invested capital, and computed an excess profits tax deficiency for 1944. (R. 32, 48–50, 164.) The Tax Court agreed with the Commissioner. It held that taxpayer's equity invested capital consisted of the net amount of cash received from the sale of its A stock ($4,358,705.70), plus the fair market value ($25,000) of the 1,000 shares of B stock issued for Foster's property; and that the commissions received by Otis were not includible in taxpayer's equity invested capital. (R. 164–167.) The Court of Appeals, one judge dissenting, affirmed. (R. 190–206.)

ARGUMENT

1. Section 718 (a) of the Internal Revenue Code, *supra,* p. 2, defines "equity invested capital" for purposes of determining the excess profits credit of a corporation[1] as the sum of (1) "money paid in" and (2) "property paid in" for stock. In

[1] The excess profits tax is imposed upon the "adjusted excess profits net income." (Section 710.) The chief adjustment factor is the "excess profits credit," which may be determined in either of two ways—under the "income" method (Section 713) or the "invested capital" method (Section 714). Taxpayer here computed its excess profits credit on the invested capital basis.

holding that the profit realized by Otis & Company on the sale of taxpayer's Class A stock to the public was not includible in taxpayer's equity invested capital, the courts below followed the established rule that only the net amount received by a corporation for its stock may be taken into account. Commissions or profits retained by an underwriter or broker in connection with the marketing of the stock do not represent invested capital within the meaning of Section 718 (a). They are paid to procure the invested capital, but are not a part of it for purposes of computing excess profits tax liability. *Simmons Co.* v. *Commissioner,* 33 F. 2d 75 (C. A. 1), certiorari denied, 280 U. S. 588; *Warner Co.* v. *Commissioner,* 11 T. C. 419, 432–434, affirmed *per curiam,* 181 F. 2d 599 (C. A. 3); *Cleveland Graphite Bronze Co.* v. *Commissioner,* 10 T. C. 974, 986–7, affirmed *per curiam,* 177 F. 2d 200 (C. A. 6); *Palomar Laundry Co.* v. *Commissioner,* 7 T. C. 1300; *Graton & Knight Co.* v. *Commissioner,* decided August 22, 1949 (1949 P-H T. C. Memorandum Decisions, par. 49206); A. R. R. 6970, III–1 Cum. Bull. 390 (1924). Cf. *LaBelle Iron Works* v. *United States,* 256 U. S. 377; *American Business Credit Corp.* v. *Commissioner,* 9 T. C. 1111, 1118.

Even though commissions paid to an underwriter or broker in connection with the sale of stock may constitute capital expenditures of the corporation, not all capital expenditures represent "invested capital" as that term is used in

Section 718 (a). See *Simmons Co.* v. *Commissioner, supra; Palomar Laundry Co.* v. *Commissioner, supra.* In *LaBelle Iron Works* v. *United State, supra,* this Court stated (p. 387) that invested capital for excess profits tax purposes has reference only to "capital actually embarked" in the business. See also *Willcuts* v. *Milton Dairy Co.,* 275 U. S. 215. Applying that concept, the Court of Appeals in the *Simmons Co.* case, *supra,* held that a corporation whose stock was sold to the public through bankers could include in its invested capital only the net proceeds of the sale, exclusive of the commission paid to the bankers.[2] This Court denied certiorari, and there is no more occasion for further review of this case than of that one.

2. Taxpayer's petition proceeds upon the hypothesis, rejected by both courts below, that its Class A stock was issued for "property" rather than for "money."[3] It is plain from the prospectus

[2] The statutory provision under construction in the *Simmons Co.* case (Section 326 (a) of the Revenue Act of 1918, c. 18, 40 Stat. 1057) was the forerunner of, and substantially the same as, Code Section 718 (a) here involved.

[3] Where stock is issued for "property," Section 718 (a) (2) applies and the adjusted basis of the property is includible in invested capital. Section 35.718–1 of Regulations 112 (quoted in fn. 2 of the Tax Court's opinion (R. 165)) provides that if the basis of property to the taxpayer is cost, and if the stock had a fair market value at the time of its issuance, the cost of the property is deemed the fair market value of the stock. If the stock had no established market value, the net worth of the company is deemed to represent the total value of the outstanding stock.

under which the Class A shares were sold (R. 85–88), to say nothing of the other stipulated facts (R. 69, 161), that the A shares were sold to the public by Otis on a when-issued basis for $25 per share. That taxpayer used the net cash proceeds to purchase property does not alter the fact that the A stock was sold for "money" as that term is used in Section 718 (a) (1).

The error in taxpayer's approach is compounded by its corollary assumption that Otis purchased Foster's property and then resold the property to taxpayer in exchange for taxpayer's stock. As is plain from the stipulated facts, and as the Tax Court pointed out (R. 165–167), Otis, acting in the capacity of underwriter, bought and resold taxpayer's stock, not Foster's property.[4] It organized taxpayer corporation to purchase the property, and enabled taxpayer to raise the cash portion of the price by marketing its Class A stock to the public. It sold the A stock for $4,950,000, turned over $4,358,705.70 to Foster on taxpayer's behalf, and retained the balance as part of its underwriter's commission. Foster then transferred his property to taxpayer for the $4,358,705.70 cash and 1,000 shares of B stock.

[4] This is confirmed by the testimony of Mr. Eaton, partner of Otis & Company. He testified that Otis & Company was engaged in the "brokerage business" and the "buying and selling of securities" (R. 126); that Otis acted as "the underwriters that bought the securities to resell" (R. 134–135); and that Otis' "gross profit was $2.50 per share of which the dealer got $1." (R. 141.)

(R. 68–70, 161–162.) That Otis paid the cash directly to Foster (on taxpayer's behalf) is entirely consistent with its role of underwriter and scarcely furnishes any basis for assuming, as does taxpayer, that Otis was purchasing Foster's business assets rather than taxpayer's stock. Taxpayer is here attempting to distort a cash purchase of property by a newly organized corporation into a sale of the property to the underwriting firm which organized the corporation and marketed its securities, in the hope of including in its invested capital amounts never paid into it but retained by the underwriter.

Stated in the language of Section 718 (a) all of taxpayer's Class A stock was issued for "money paid in" to it by Otis, and this money together with one-half of its Class B stock was used by taxpayer to purchase "property paid in" to it by Foster. The balance of the proceeds of the sale of the Class A stock, and the other half of the Class B stock, went to Otis as its underwriter's fee.

In any event, this contention involves only a question relating to the particular facts of this case.

3. Taxpayer relies for conflict (Pet. 6; Br. 26–30) solely upon *Hazeltine Corp.* v. *Commissioner* 89 F. 2d 513 (C. A. 3). That case involved the depreciation basis of property acquired by a corporation in exchange for stock. No question of invested capital was even remotely pre-

sented. The court below aptly observed (R. 203) that the case is "far afield", and that (R. 204) the issue here is the entirely different one of whether profits accruing to an underwriter from the sale of stock are includible in the corporation's equity invested capital for excess profits tax purposes. The cases uniformly hold that such profits are not includible, and taxpayer suggests no reason for departing from them here.

CONCLUSION

The decision below is correct. There is no conflict, and no occasion for further review. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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